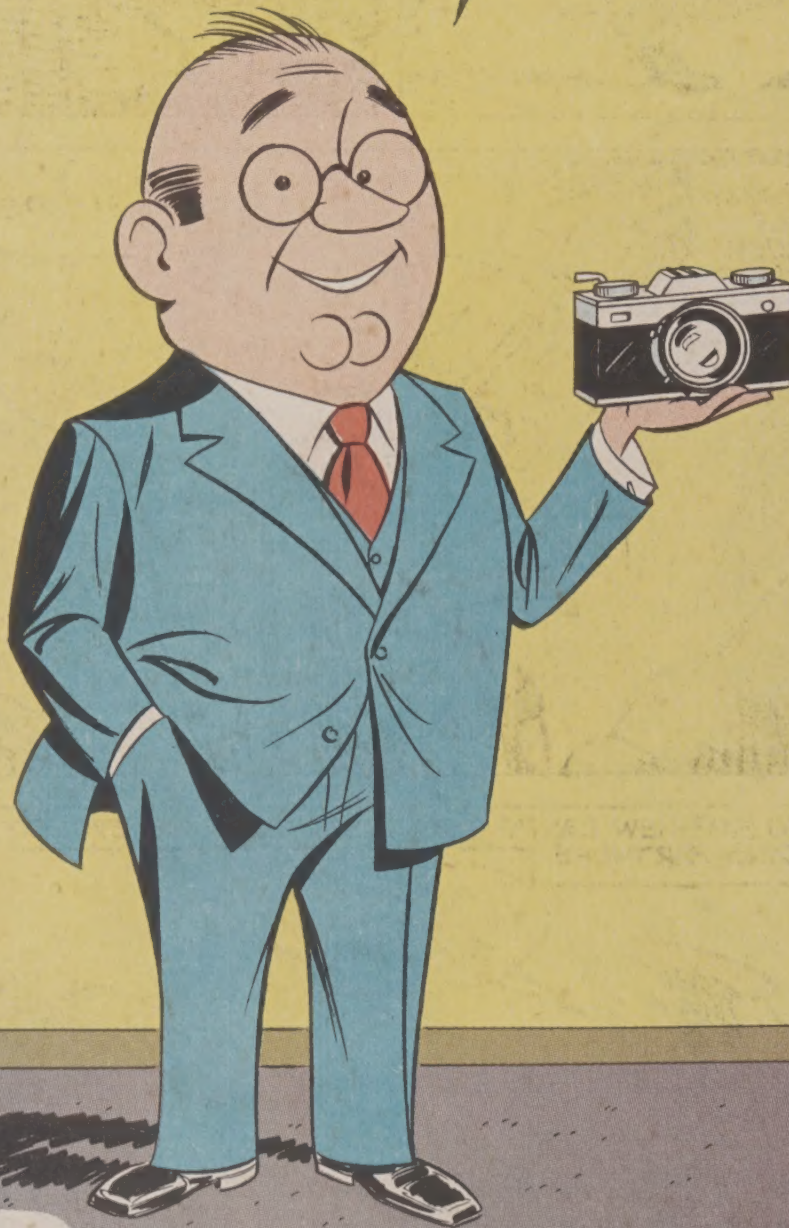


THE STORY OF
FOREIGN TRADE
AND
EXCHANGE



**FEDERAL RESERVE BANK
OF NEW YORK**

THIS SUIT AND MY CAMERA WERE MADE
IN THE FAR EAST. MY WIFE USES FRENCH PERFUME
AND OWNS SOME STOCK IN A GERMAN COMPANY.
CAN YOU EXPLAIN WHY SUCH INTERNATIONAL TRADE
AND INVESTMENT TOOK PLACE? OR WHY, SAY, 1500
SPANISH PESETAS IS THE EQUIVALENT OF \$10 AND
NOT \$7. WE ARE GOING TO FIND THE ANSWERS
TO THESE QUESTIONS. BUT FIRST LET'S TURN BACK
THE CLOCK A BIT.



ART BY
AL WENZEL

FOR CENTURIES, MEN FOUGHT TO DOMINATE TRADE. THEY FOUGHT FOR BOOTY AND ADVENTURE, BUT THEY ALSO FOUGHT FOR THE POWER AND WEALTH OF THEIR NATIONS.

WADDYA SAY WE
SPLIT IT 50-50!



ACCORDING TO THE THEORY OF THE TIME, **MERCANTILISM** (1500-1850s), A NATION'S POWER AND WEALTH WERE ASSURED IF IT HAD VAST STORES OF GOLD OR SILVER.

EVERY TIME I GET A LITTLE
AHEAD, THE CASTLE GETS
REDECORATED.



COUNTRIES ACQUIRED
PRECIOUS METALS
THROUGH PLUNDER
OR DISCOVERIES OF
NEW MINES.

I THINK I
PREFER PLUNDER!

ME
TOO.



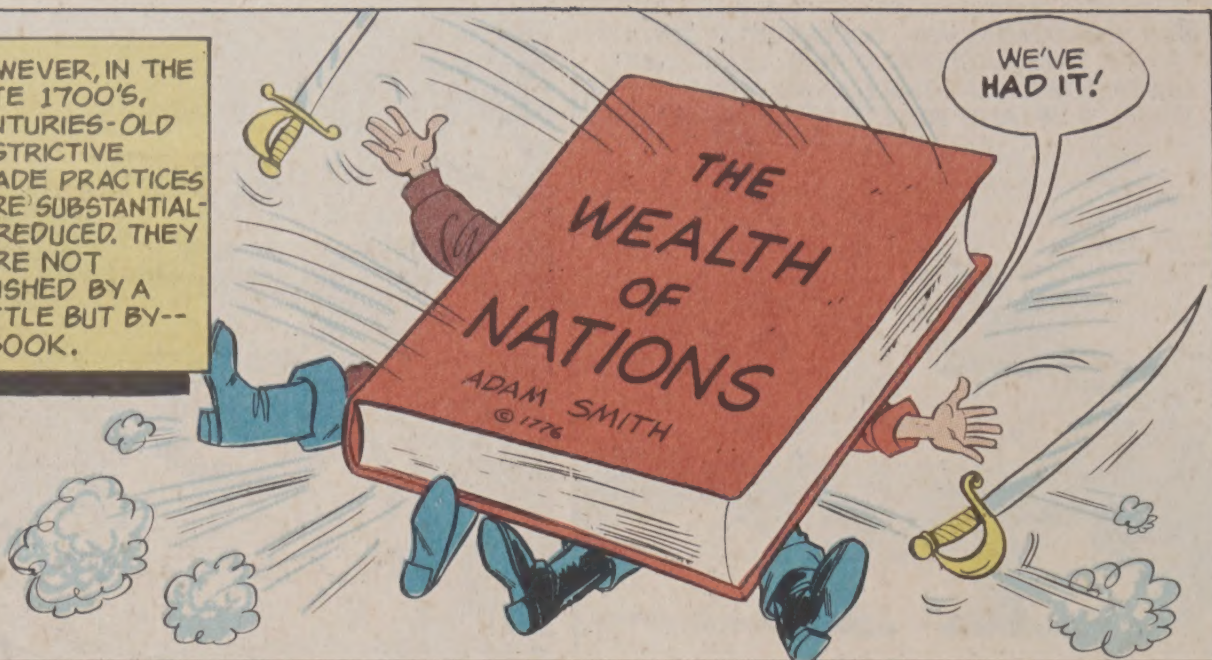
THEY COULD ALSO FIND NEW LANDS THEY COULD COLONIZE, EXPLOIT AND MAKE THEIR EXCLUSIVE TRADING PARTNERS.

SEE
ANY
GOLD?

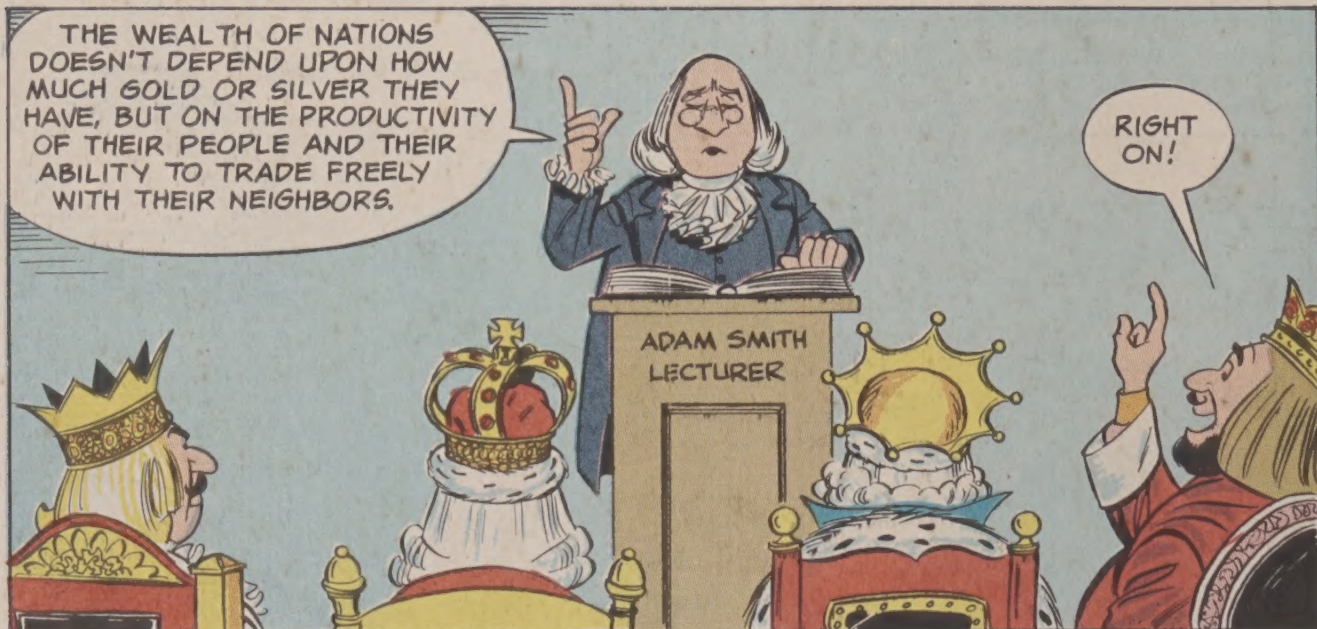
YEAH! ONE OF
THOSE NATIVES HAS A
GOLD WATCH!



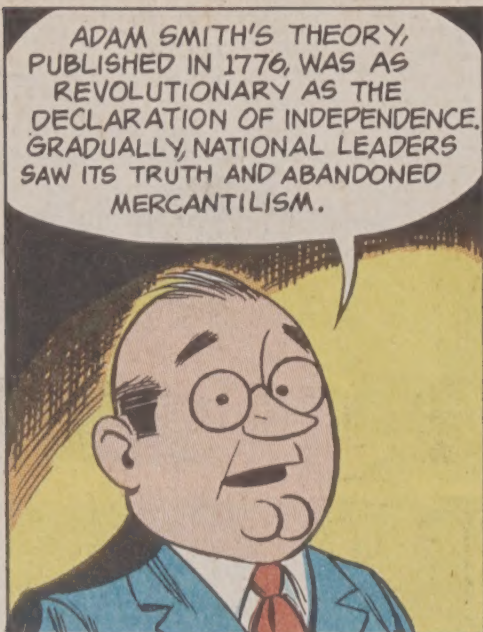
HOWEVER, IN THE LATE 1700'S, CENTURIES-OLD RESTRICTIVE TRADE PRACTICES WERE SUBSTANTIAL-
LY REDUCED. THEY WERE NOT FINISHED BY A BATTLE BUT BY--
A BOOK.



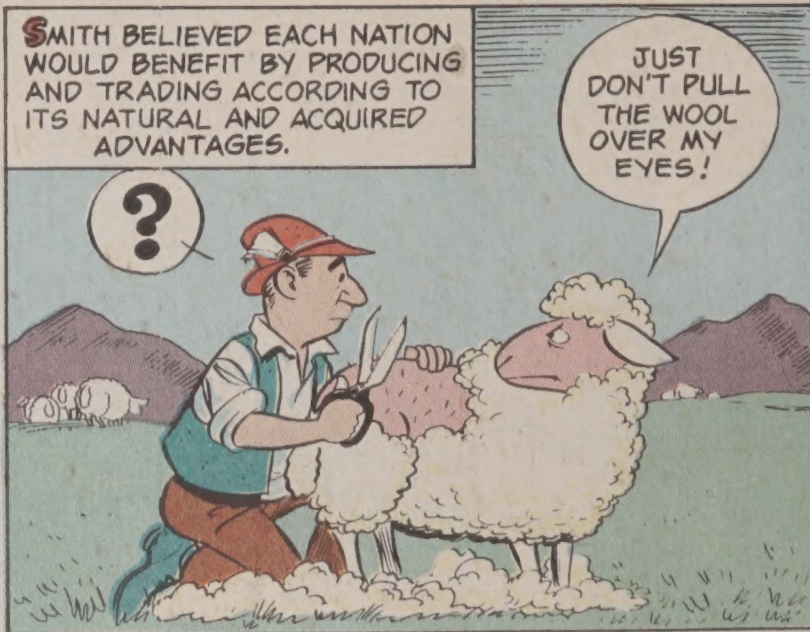
THE WEALTH OF NATIONS DOESN'T DEPEND UPON HOW MUCH GOLD OR SILVER THEY HAVE, BUT ON THE PRODUCTIVITY OF THEIR PEOPLE AND THEIR ABILITY TO TRADE FREELY WITH THEIR NEIGHBORS.



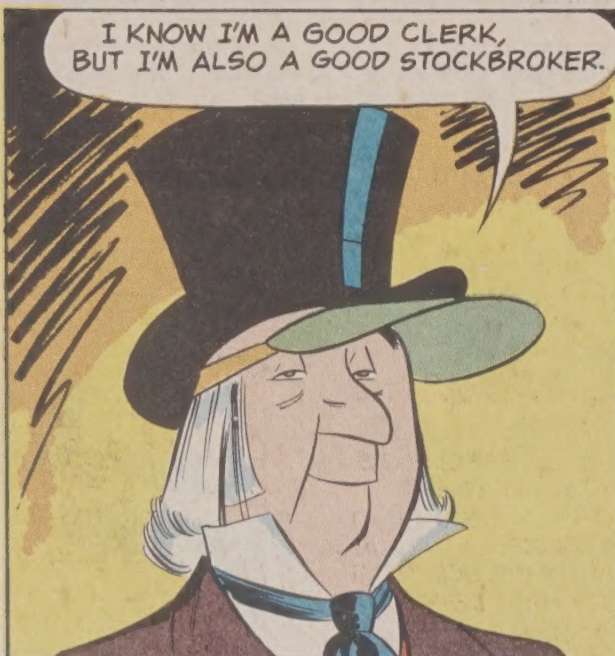
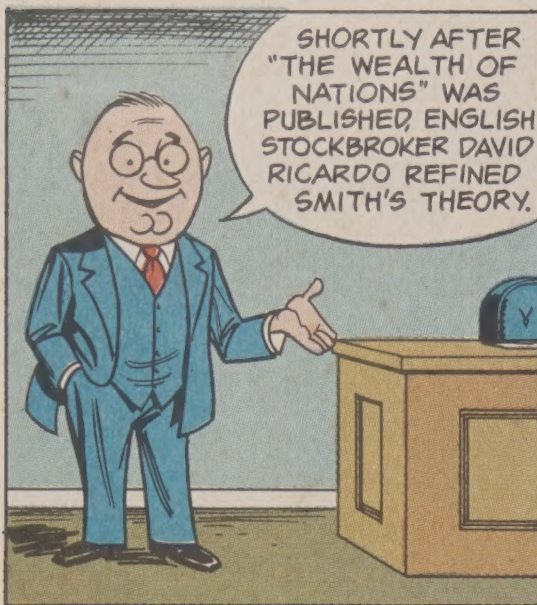
ADAM SMITH'S THEORY, PUBLISHED IN 1776, WAS AS REVOLUTIONARY AS THE DECLARATION OF INDEPENDENCE. GRADUALLY, NATIONAL LEADERS SAW ITS TRUTH AND ABANDONED MERCANTILISM.

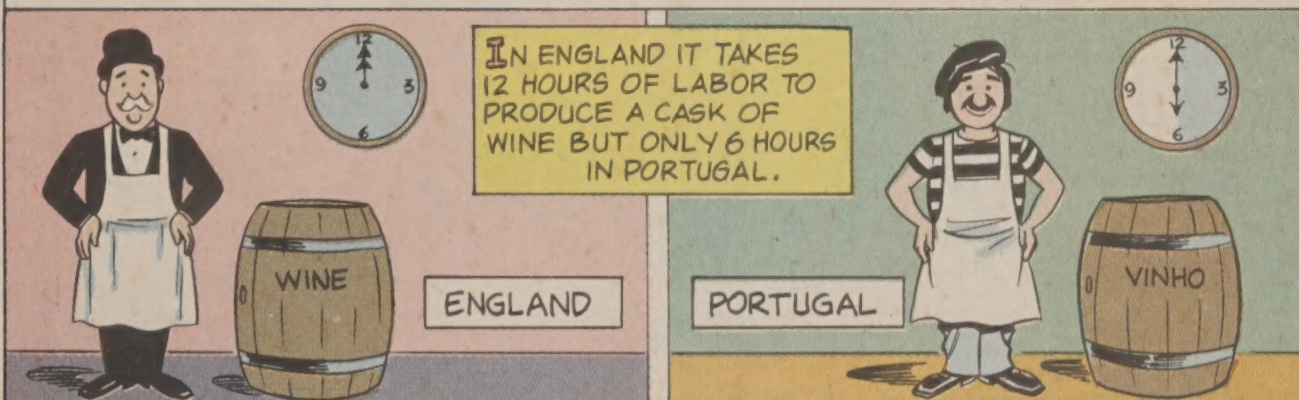
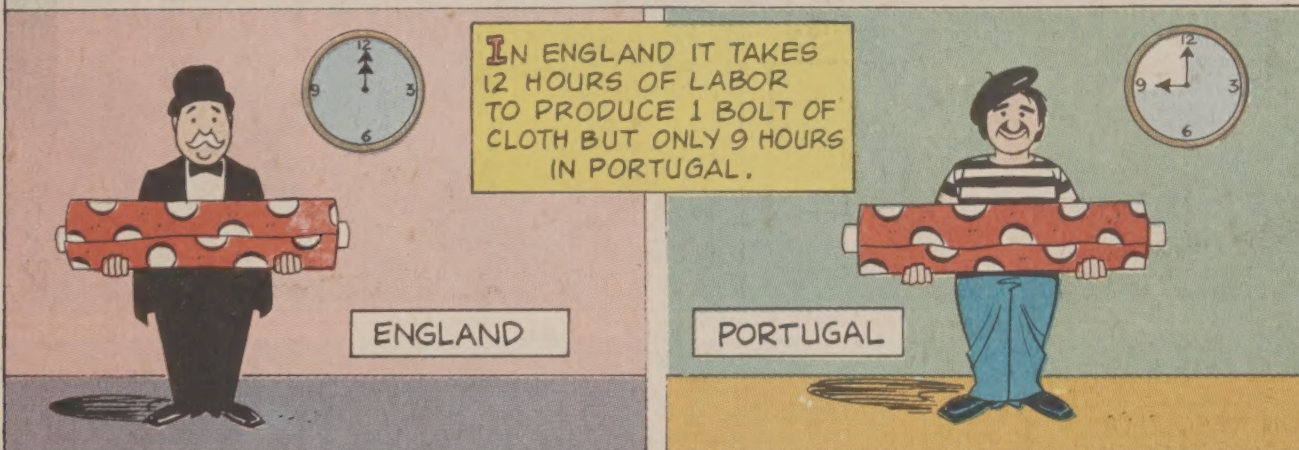


SMITH BELIEVED EACH NATION WOULD BENEFIT BY PRODUCING AND TRADING ACCORDING TO ITS NATURAL AND ACQUIRED ADVANTAGES.



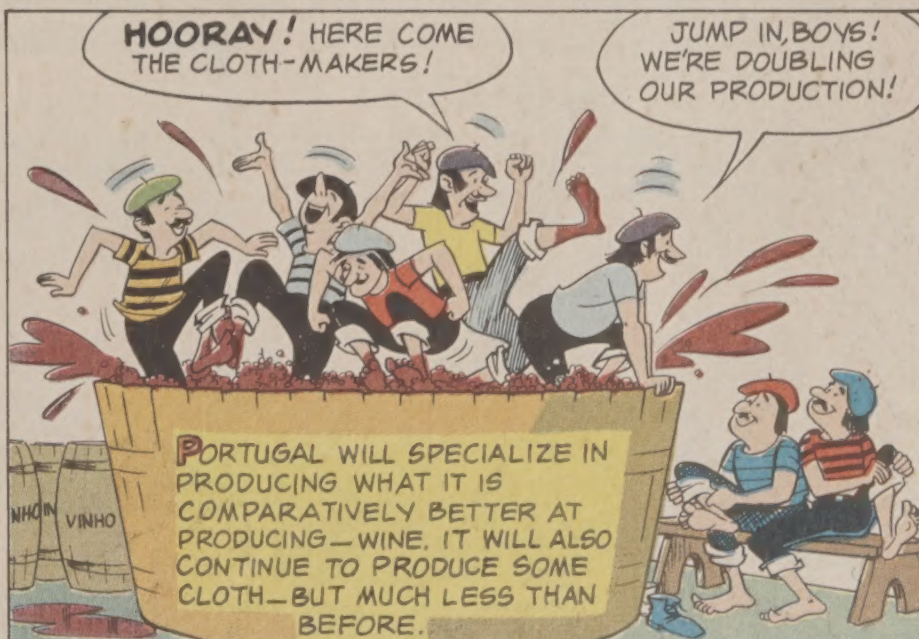
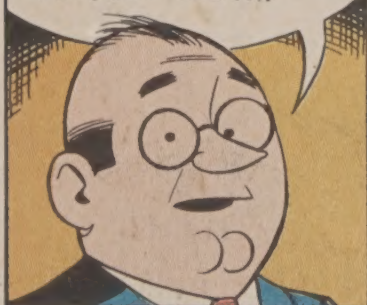


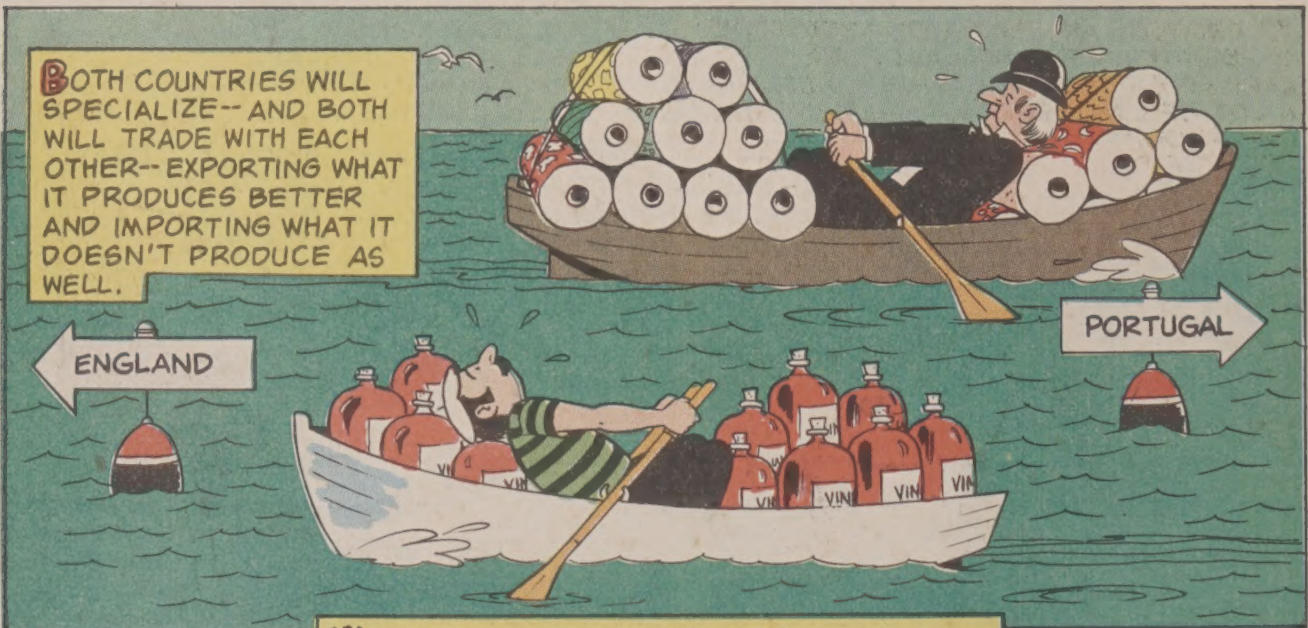




ASSUMING LABOR IS THE MOST IMPORTANT INGREDIENT IN THE PRODUCTION OF WINE AND CLOTH, PORTUGAL CAN MAKE EACH PRODUCT CHEAPER BECAUSE IT HAS AN **ABSOLUTE ADVANTAGE** IN PRODUCING BOTH WITH LESS LABOR.

BUT PORTUGAL HAS A **COMPARATIVE ADVANTAGE** IN THE PRODUCTION OF WINE SINCE IT NEEDS 50% LESS LABOR TIME THAN DOES ENGLAND TO PRODUCE A CASK COMPARED TO ONLY 25% LESS LABOR TIME TO PRODUCE CLOTH.





RICARDO'S THEORY WORKED, BUT FOR MORE THAN A CENTURY NO ONE REALLY UNDERSTOOD WHY. IN 1933, SWEDISH ECONOMIST BERTIL OHLIN CAME UP WITH AN ANSWER.

BECAUSE NATIONS HAVE DIFFERENT AMOUNTS OF THE FACTORS OF PRODUCTION, THEY MAY BE CAPABLE OF PRODUCING THE SAME THINGS, BUT NOT AT THE SAME PRICE. HERE'S WHY:

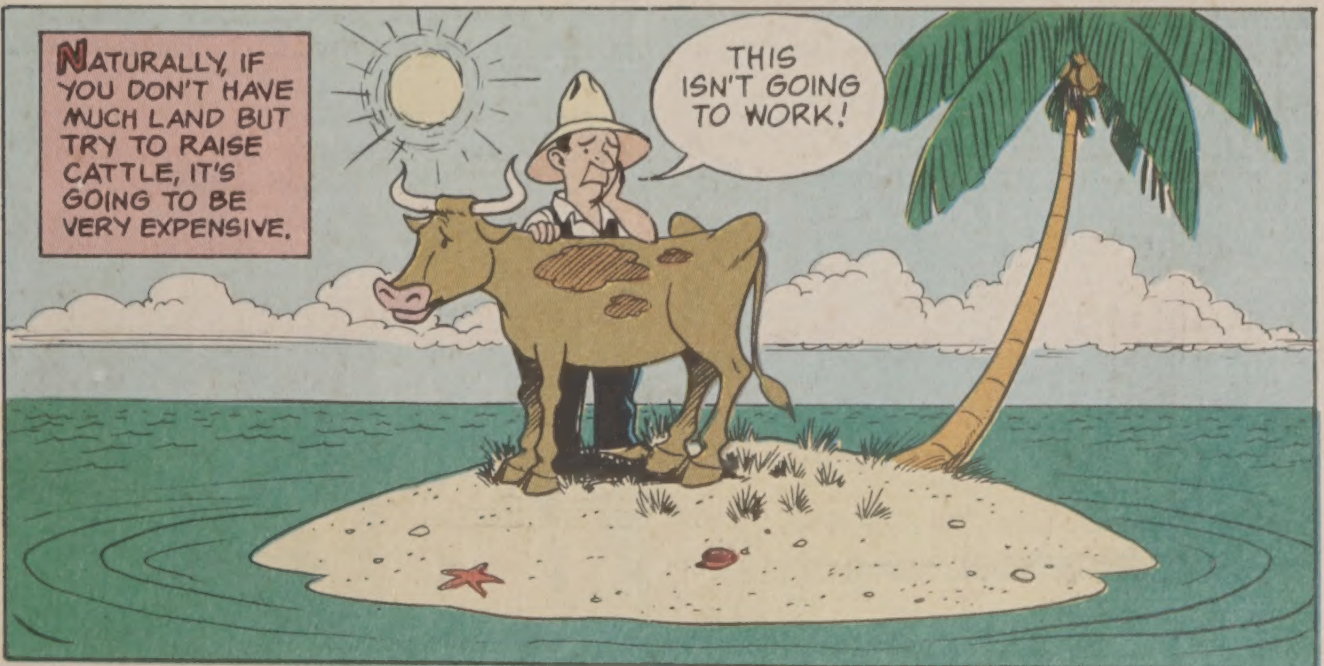


TO PRODUCE ANYTHING, YOU NEED SOME COMBINATION OF LAND, LABOR AND CAPITAL. CATTLE, FOR EXAMPLE, REQUIRE A LOT OF LAND, BUT NOT MUCH CAPITAL OR LABOR.

OTHER ITEMS, LIKE THIS HOME COMPUTER, REQUIRE A LOT OF CAPITAL OR SOPHISTICATED MACHINERY, BUT NOT MUCH LAND OR LABOR.



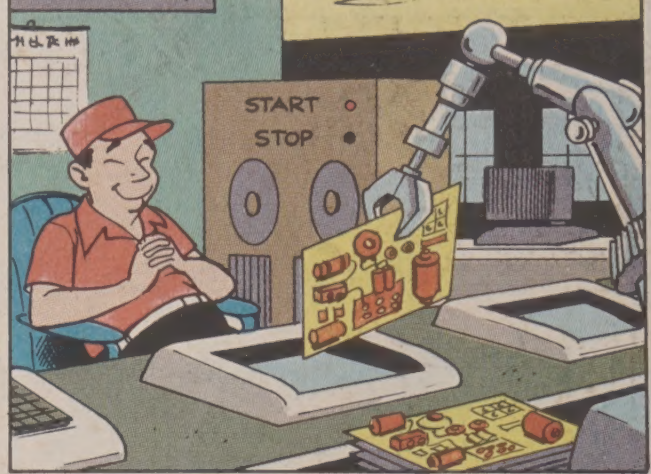
NATURALLY, IF YOU DON'T HAVE MUCH LAND BUT TRY TO RAISE CATTLE, IT'S GOING TO BE VERY EXPENSIVE.



ON THE OTHER HAND, IF LAND IS RELATIVELY CHEAP, CATTLE RAISING WILL BE LESS EXPENSIVE. THE CHEAPEST CATTLE WILL COME FROM THE COUNTRY WITH THE MOST GRAZING LAND.



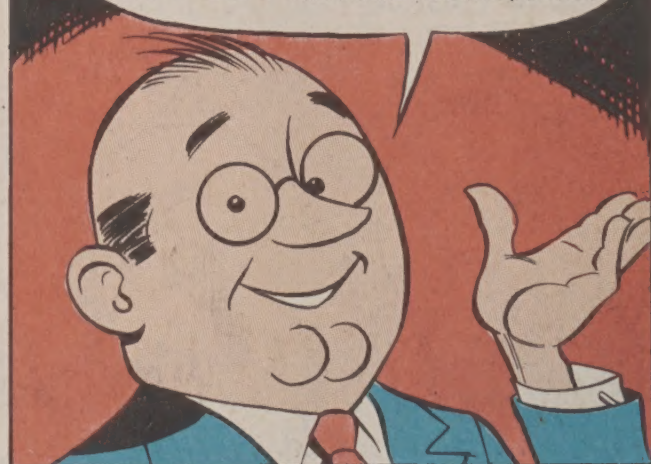
THE CHEAPEST COMPUTER WILL COME FROM THE COUNTRY WITH THE MOST SOPHISTICATED MACHINERY.



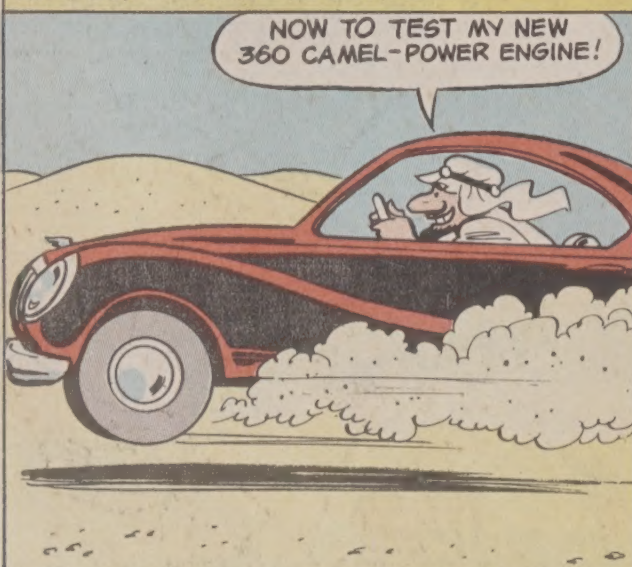
SO, SMITH AND RICARDO WERE RIGHT! AS LONG AS NATIONS SPECIALIZE IN PRODUCING GOODS REQUIRING THEIR MOST ABUNDANT FACTORS OF PRODUCTION, COMPARATIVE ADVANTAGE WORKS.



NATIONS TRADE FOR MANY REASONS. CERTAINLY FOR SOME, IT IS TO TAKE ADVANTAGE OF A NATURAL RESOURCE OR TO OBTAIN THINGS THEY CAN'T PRODUCE THEMSELVES.



BUT MOST NATIONS TRADE TO REAP THE BENEFITS THAT COULD COME FROM SPECIALIZING AND TRADING IN ACCORDANCE WITH COMPARATIVE ADVANTAGE.



COMPARATIVE ADVANTAGE, COMBINED WITH FREE TRADE, IMPROVES NATIONS' LIVING STANDARDS AND STRENGTHENS THEIR ECONOMIES.



NOW THAT WE KNOW WHY NATIONS TRADE, LET'S SEE HOW THEY PAY FOR IT.

GET GOLD! HUMANELY, IF POSSIBLE, BUT GET GOLD!



THE ORDER KING FERDINAND OF SPAIN GAVE HIS SOLDIERS IN SOUTH AMERICA IN 1511 WAS MORE THAN A ROYAL COMMAND, IT WAS A STATEMENT OF ECONOMIC POLICY.

WELL, THERE GOES THE NEIGHBORHOOD!



GOLD WAS VITAL FOR TRADE IN THOSE DAYS BECAUSE IT WAS, ALONG WITH SILVER, AN ALMOST UNIVERSAL MEDIUM OF EXCHANGE.

WOULD YOU BELIEVE IT'S A GOLDEN CHICKEN!

GOLD ONLY

NO CHECKS
NO CASH
NO CLAMS
NO CHICKENS

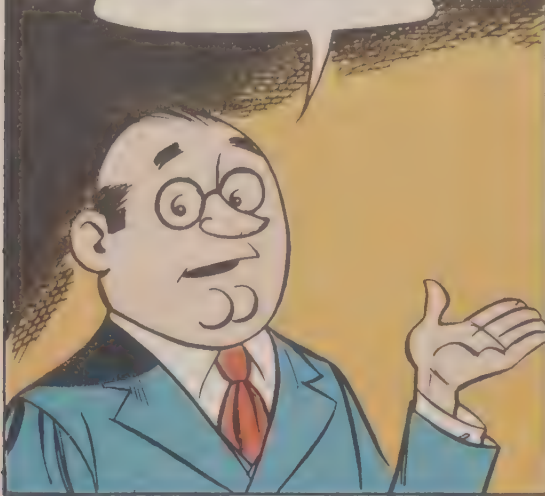


IN MOST OF THE WORLD, ANY FORM OF THESE PRECIOUS METALS WOULD BUY WHAT YOU WANTED, BECAUSE A CERTAIN WEIGHT OF EACH HAD AN AGREED UPON VALUE.

MY FAVORITE COLOR!



BUT GOLD AND SILVER HAVE BEEN REPLACED BY PAPER MONEY PRINTED BY GOVERNMENTS AND BY CHECKING ACCOUNTS ISSUED BY BANKS. WE NO LONGER HAVE A UNIVERSAL MEDIUM OF EXCHANGE.

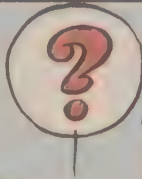


LET'S FOLLOW TEX—AN AMERICAN BUSINESSMAN—ON A GLOBE-CIRCLING BUSINESS TRIP.

AH! I'VE ALWAYS WANTED TO SEE PARIS! SURE GLAD I BROUGHT PLENTY OF MONEY!

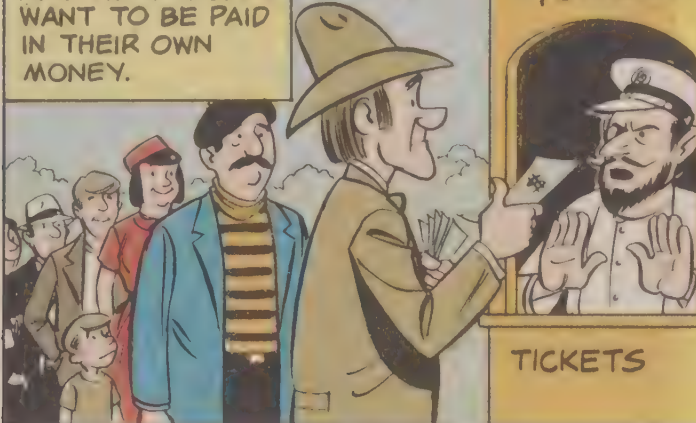


TEX FORGOT ONE THING! GENERALLY, THE MONEY OF ONE NATION CAN NOT BE USED IN ANOTHER. PEOPLE WANT TO BE PAID IN THEIR OWN MONEY.



EIFFEL TOWER

NO DOLLARS! YOU MUST BUY YOUR TICKETS WITH FRANCS!



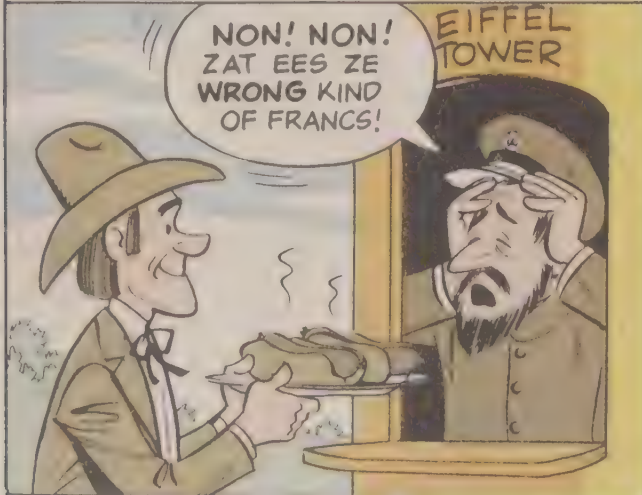
ENTRANCE

THIS MIGHT BOTHER A GLOBETROTTER LIKE TEX IF THERE WASN'T A UNIQUE MARKET THAT ALLOWS PURCHASING POWER TO BE TRANSFERRED BETWEEN CURRENCIES ...

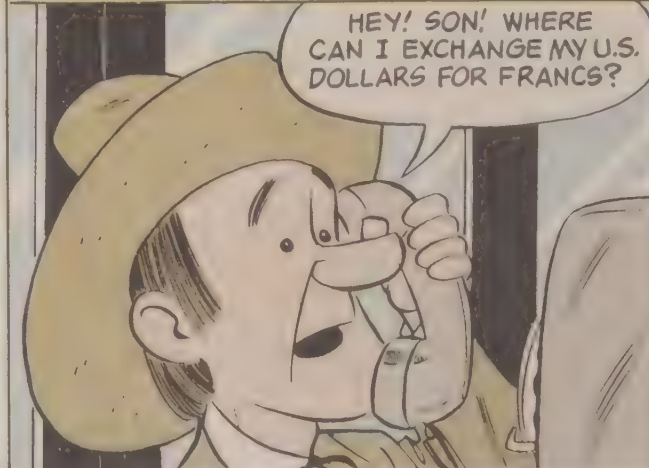
THAT'S THE FOREIGN EXCHANGE MARKET, WHICH IS WHAT WE CALL THE BANKS AND FOREIGN EXCHANGE DEALERS THAT TRADE CURRENCIES IN MAJOR CITIES LIKE NEW YORK, PARIS, AND LONDON, LARGELY BY TELEPHONE ...

NON! NON! ZAT EES ZE WRONG KIND OF FRANCS!

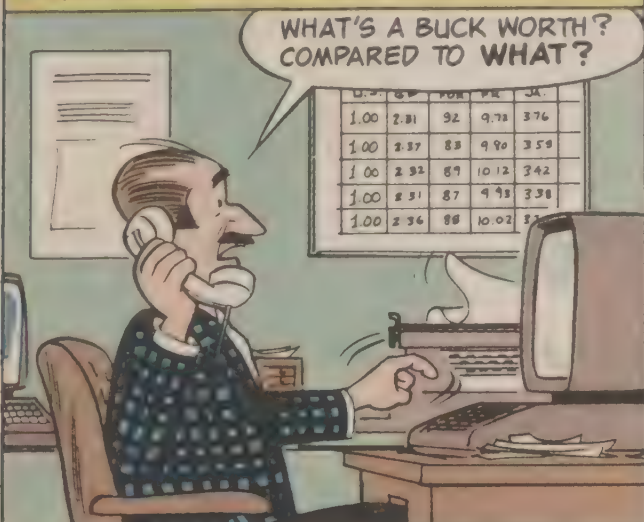
EIFFEL TOWER



HEY! SON! WHERE CAN I EXCHANGE MY U.S. DOLLARS FOR FRANCS?



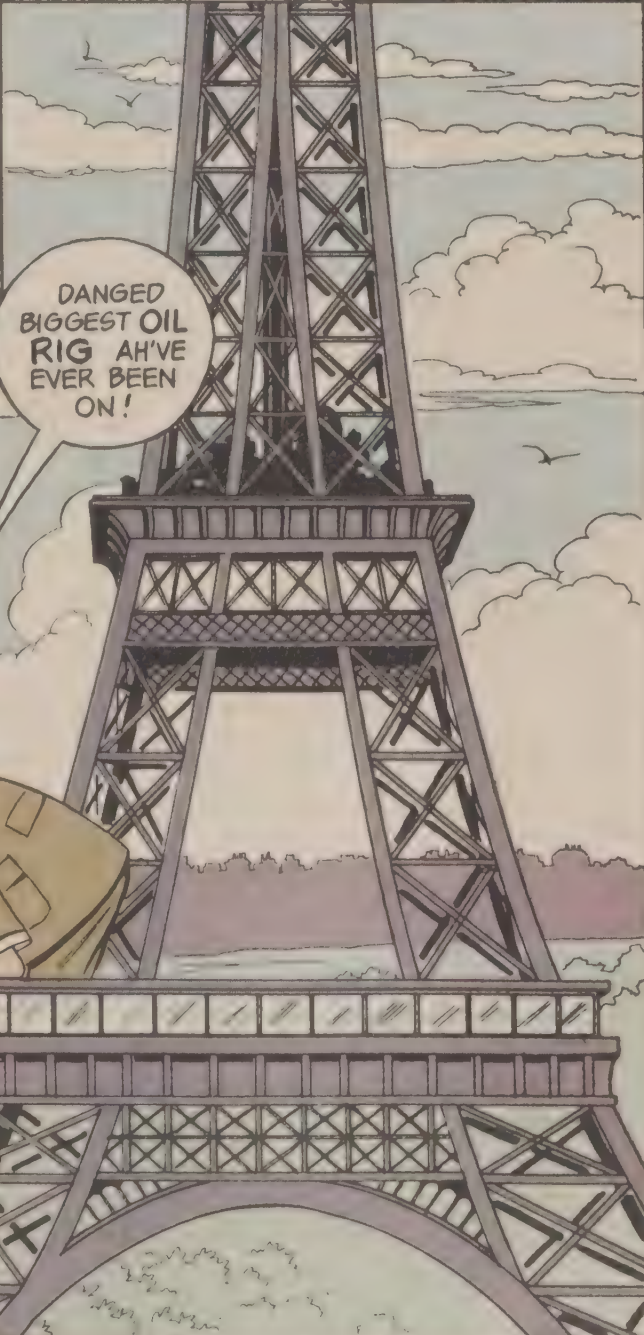
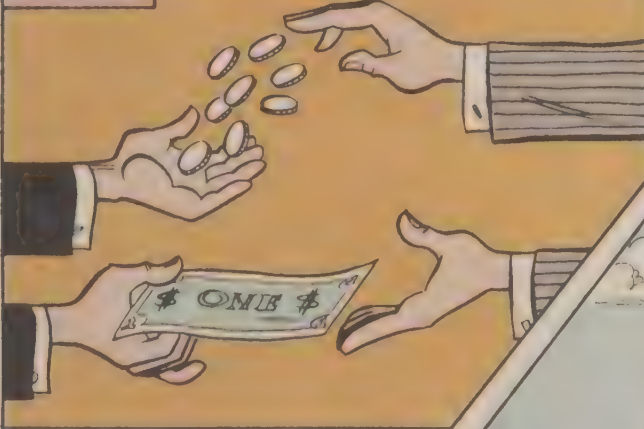
...BUT ALSO BY TELETYPE. THEY QUOTE BUYING AND SELLING PRICES-- THE FOREIGN EXCHANGE RATES OF FOREIGN MONIES DAILY.



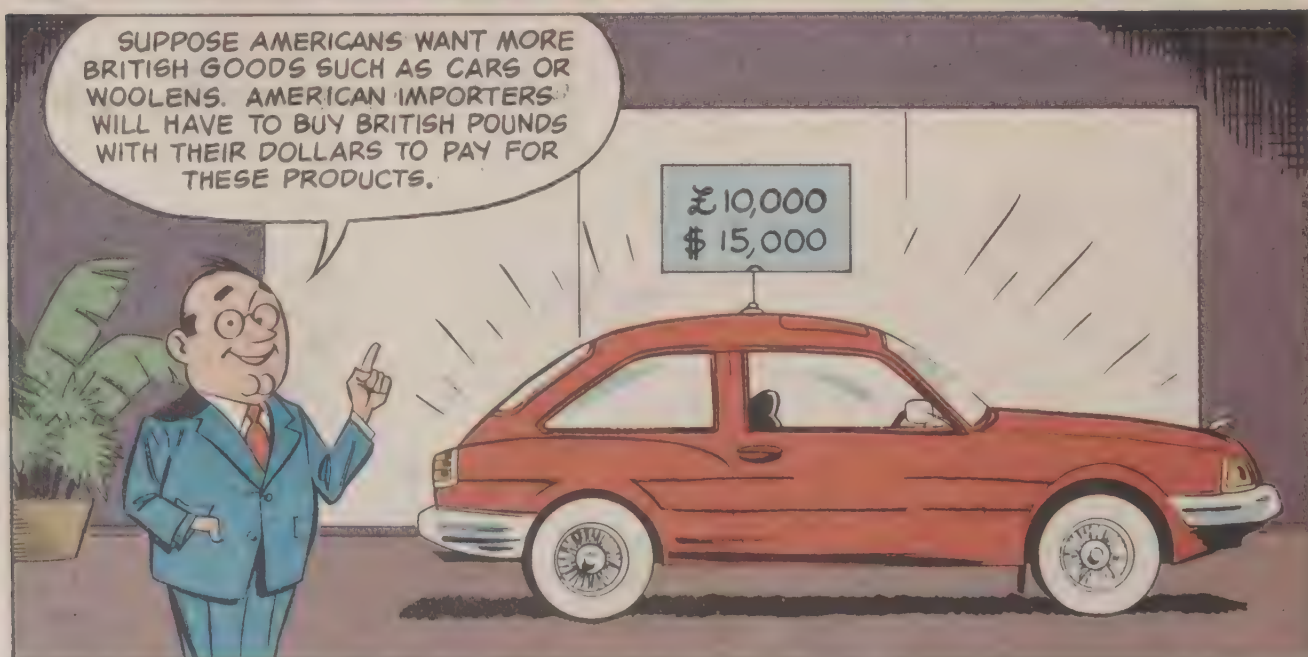
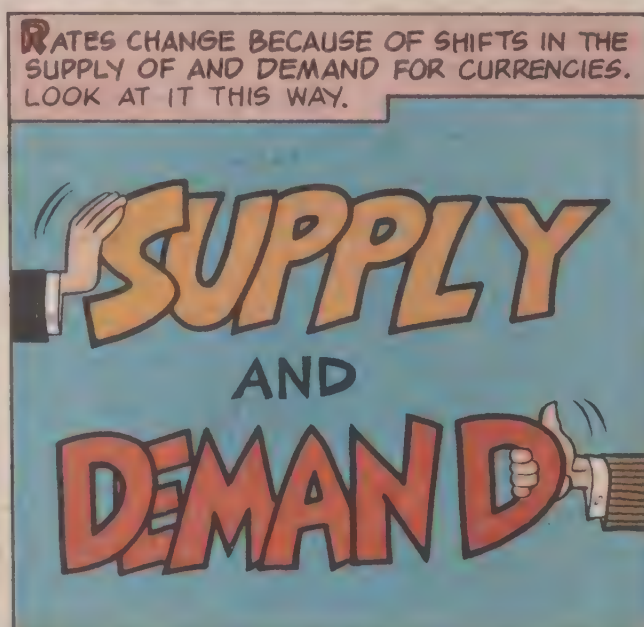
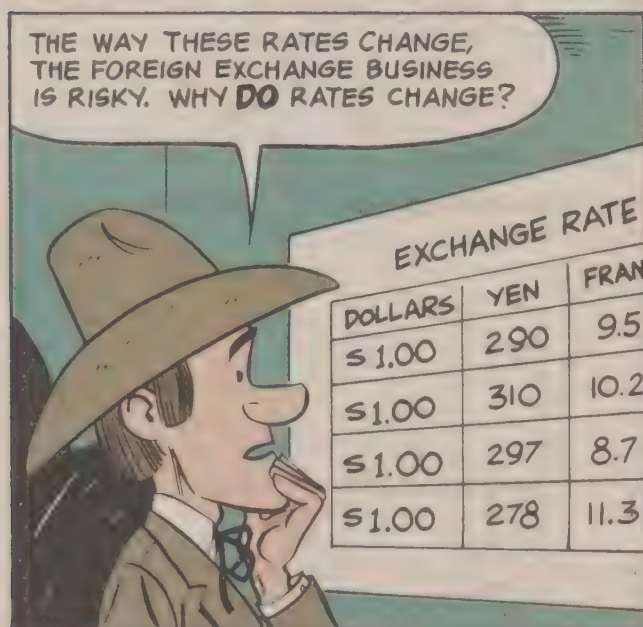
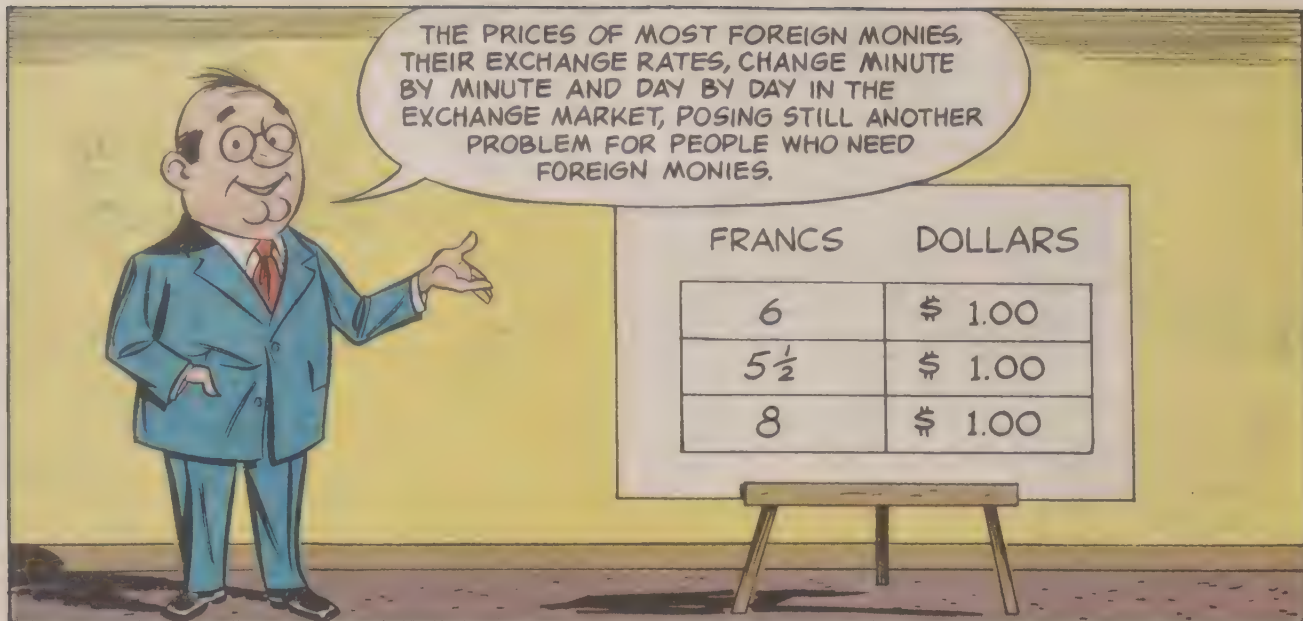
THESE RATES EXPRESS THE PURCHASING POWER OF ONE NATION'S MONEY IN RELATION TO ANOTHER'S.

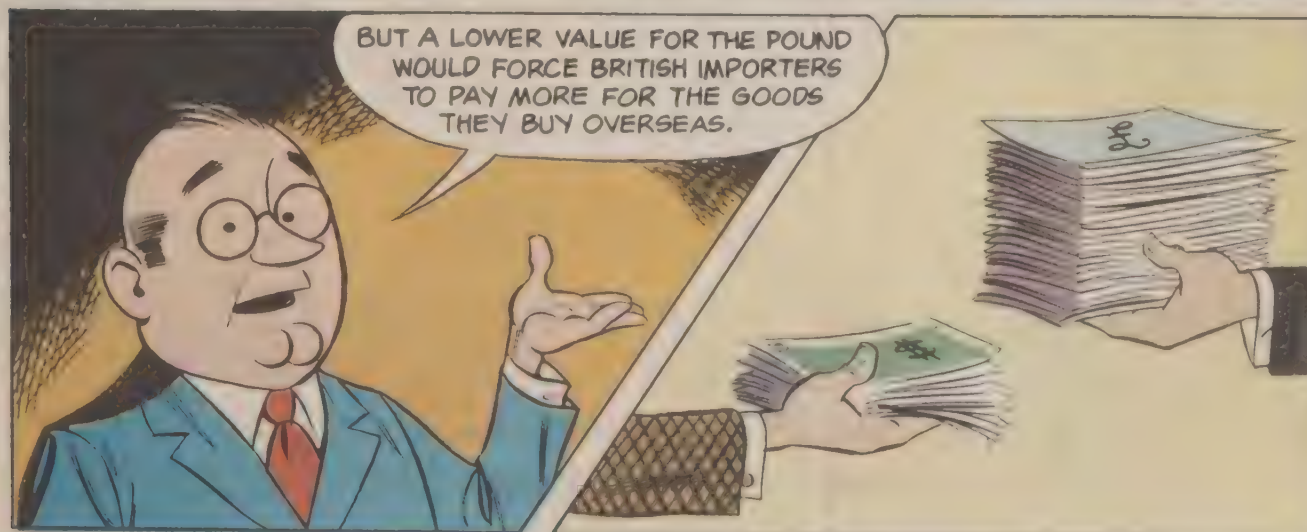
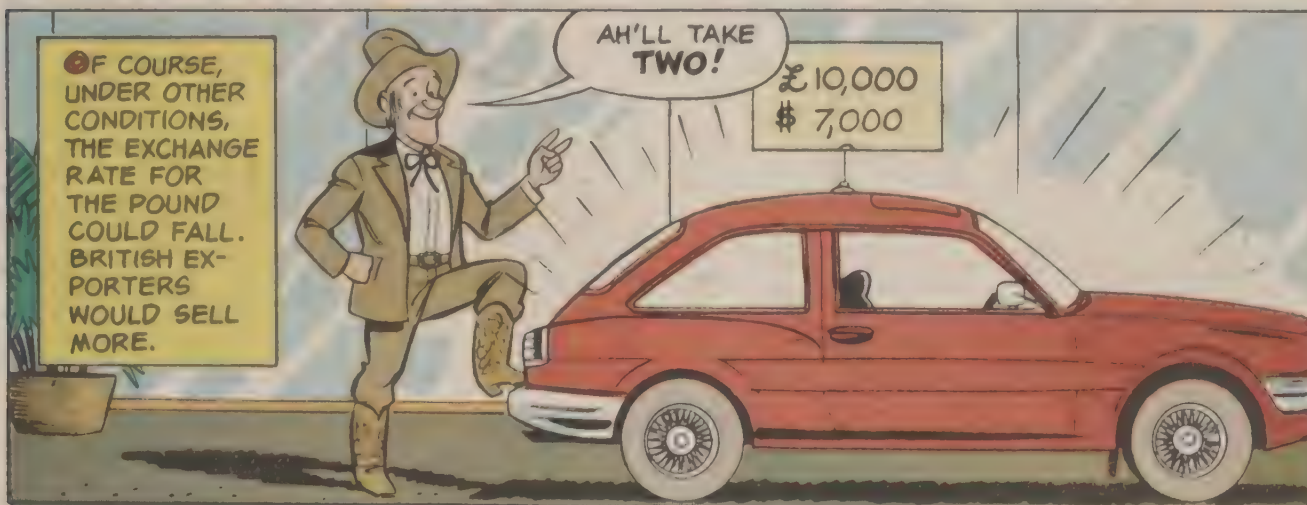
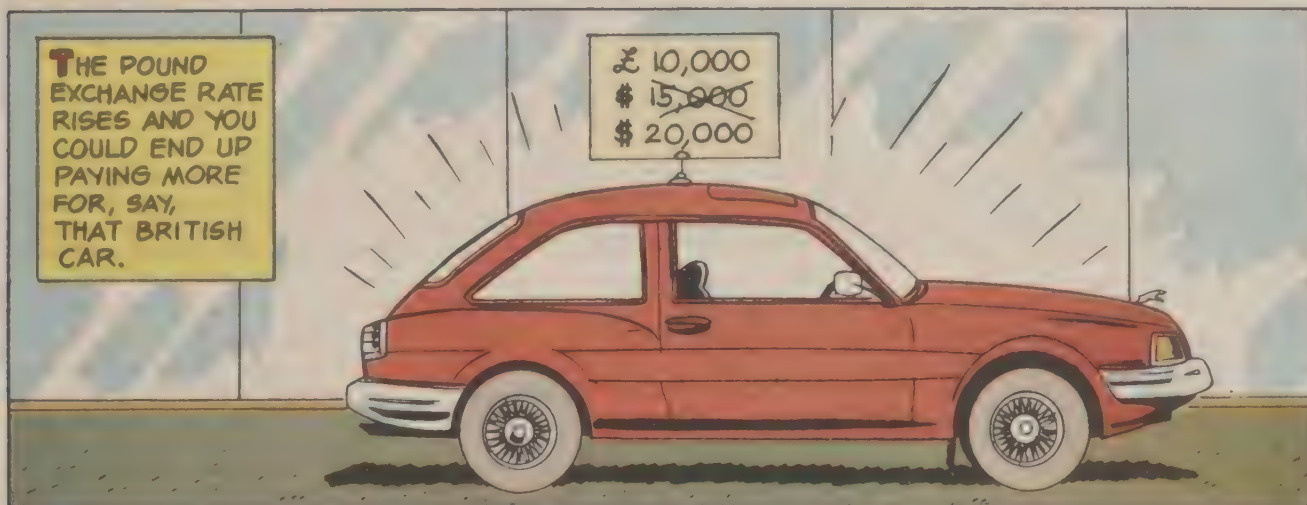
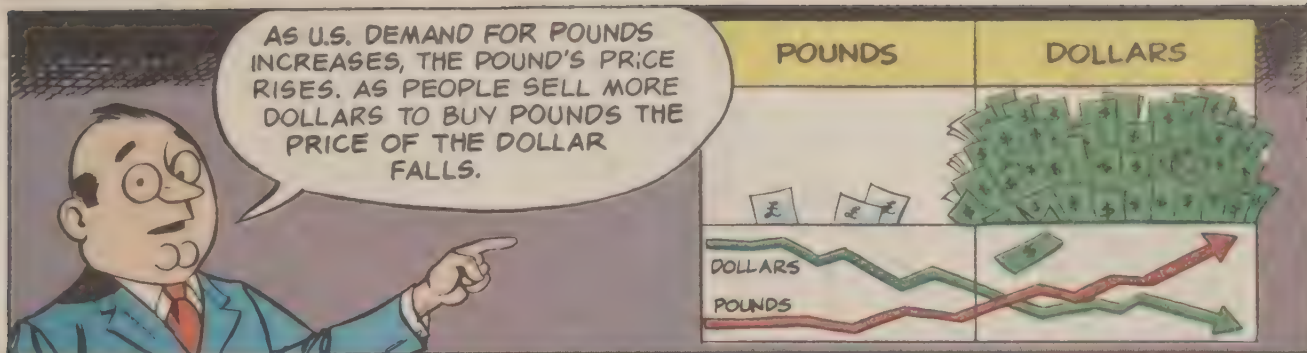


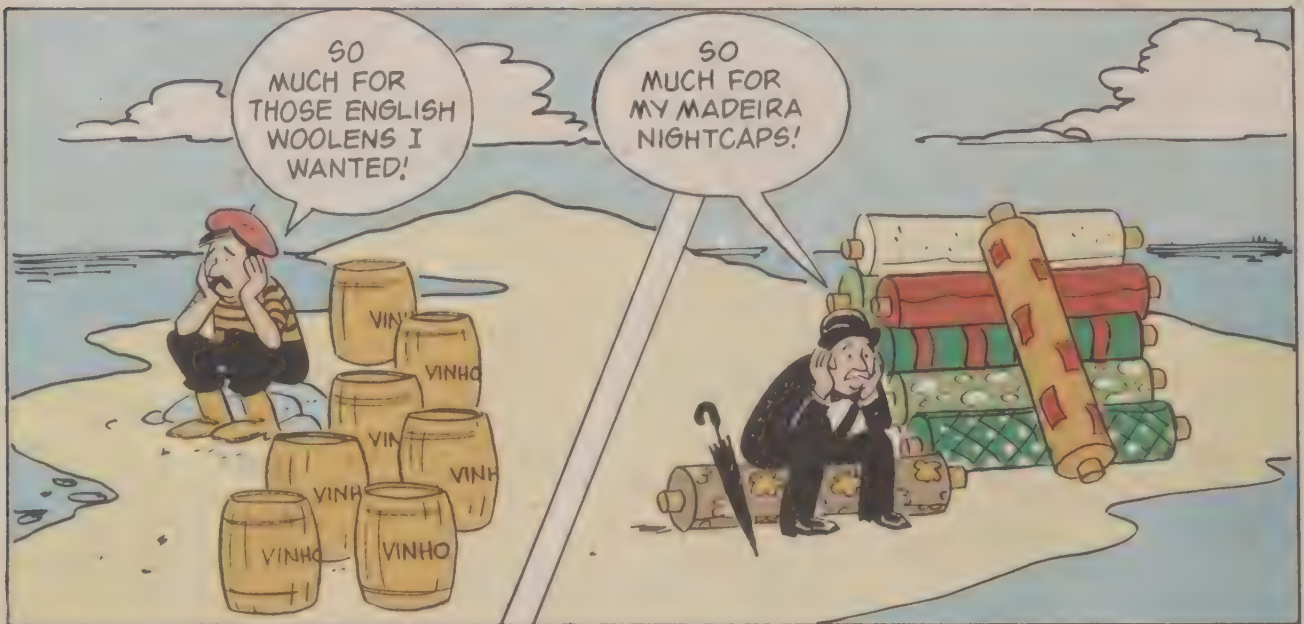
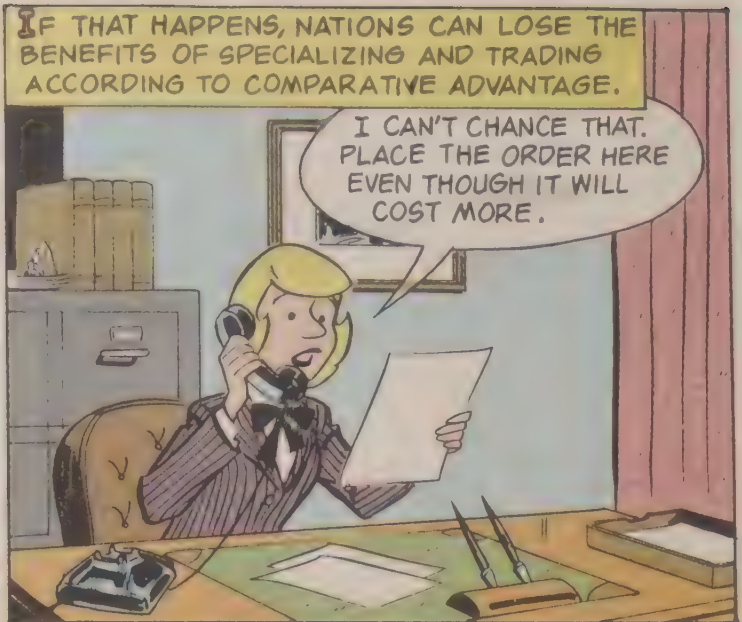
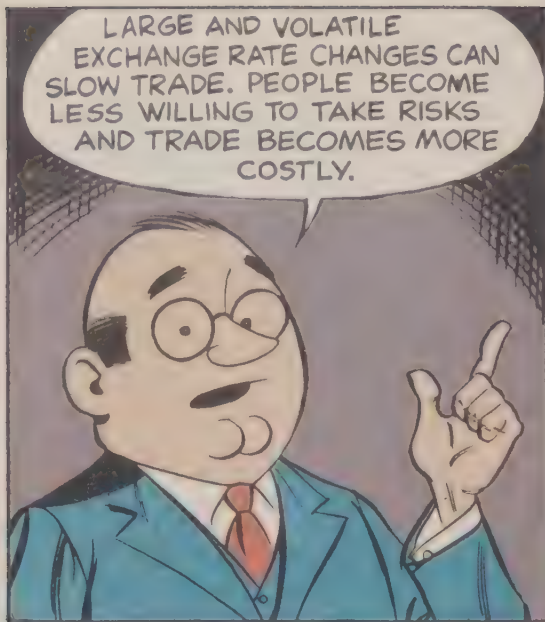
TEX HAS LEARNED THAT FRANCS TODAY ARE SELLING FOR 12 1/2 CENTS, OR EIGHT FOR A DOLLAR.



THE FOREIGN EXCHANGE MARKET NOT ONLY HELPS TOURISTS LIKE TEX, BUT IMPORTERS, EXPORTERS, AND INTERNATIONAL INVESTORS. MOST FOREIGN EXCHANGE TRANSACTIONS INVOLVE BANK BALANCES RATHER THAN CURRENCY.



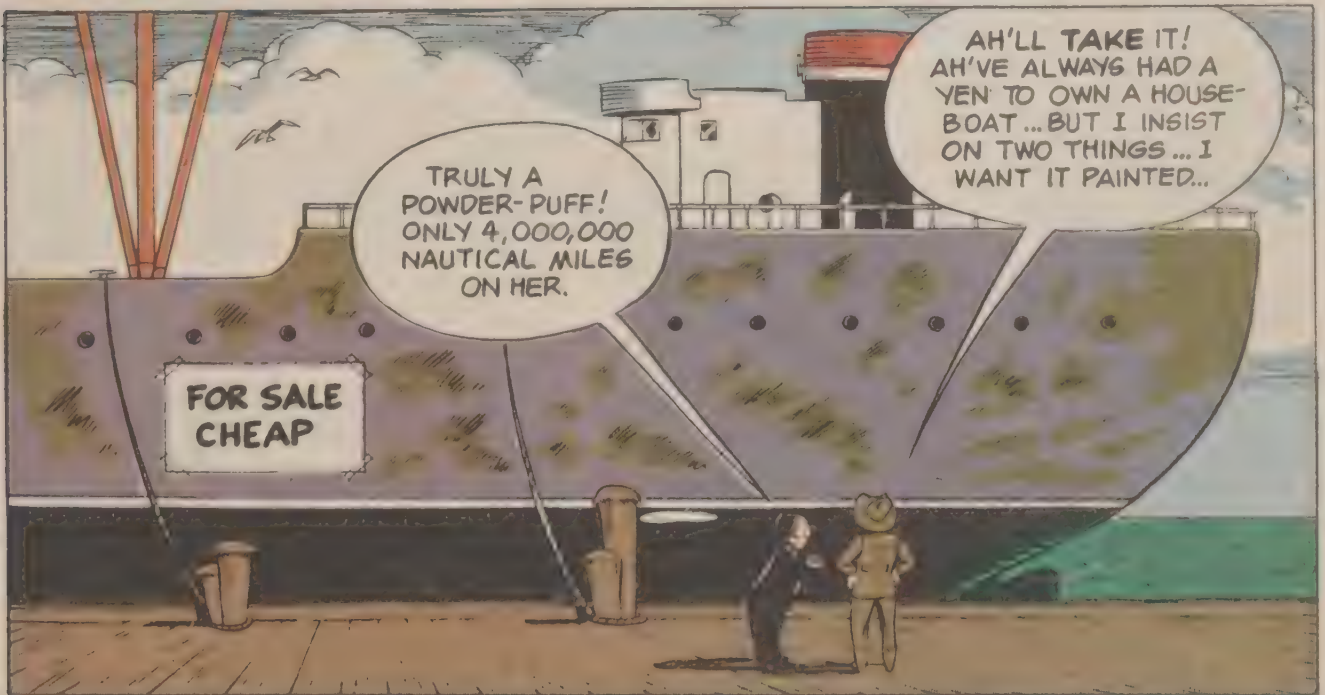
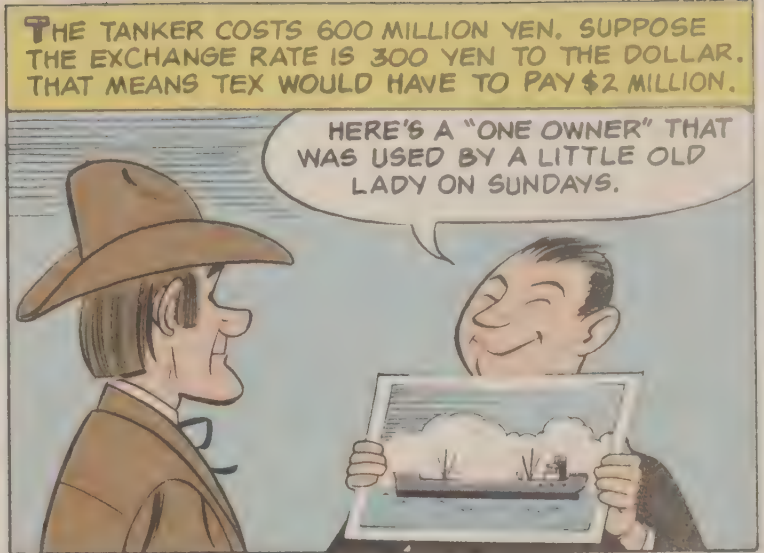
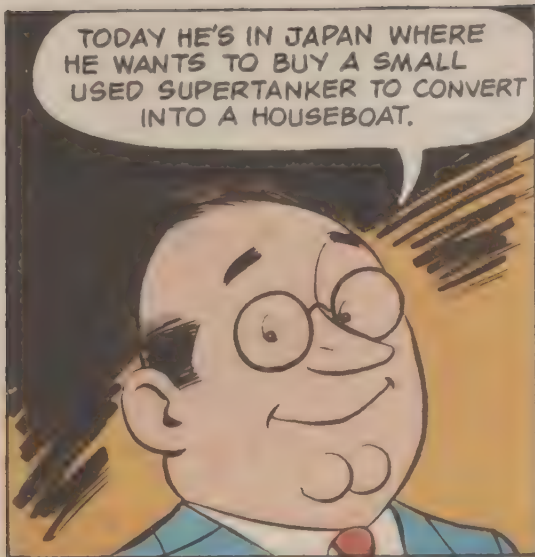


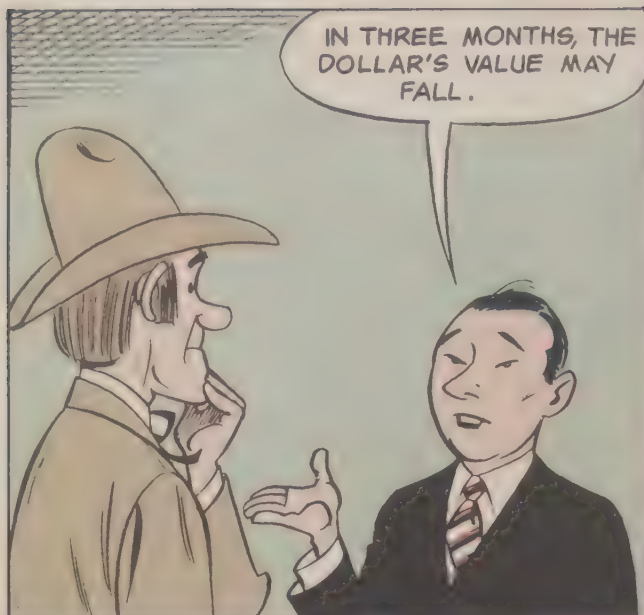


THE FOREIGN EXCHANGE MARKET COULDN'T COPE WITH WIDELY FLUCTUATING EXCHANGE RATES WITHOUT THE FORWARD CONTRACT.

DOLLARS	MARKS	FRANCS	POUNDS	PESOS	YEN
\$ 1.00	3.01	11.32	2.37	172	321
\$ 1.00	3.27	11.14	2.50	178	307
\$ 1.00	2.92	12.10	2.13	164	319
\$ 1.00	3.02	9.2	2.22	168	301
\$ 1.00	3.02	9.2	2.31	173	298
\$ 1.00	2.96	12.7	2.1	161	342
\$ 1.00	2.93	14	1.8	147	305
\$ 1.00	2.96	14	1.8	147	296
\$ 1.00	2.96	14	1.8	147	337
\$ 1.00	2.96	14	1.8	147	310
\$ 1.00	2.96	14	1.8	147	280
\$ 1.00	2.96	14	1.8	147	291







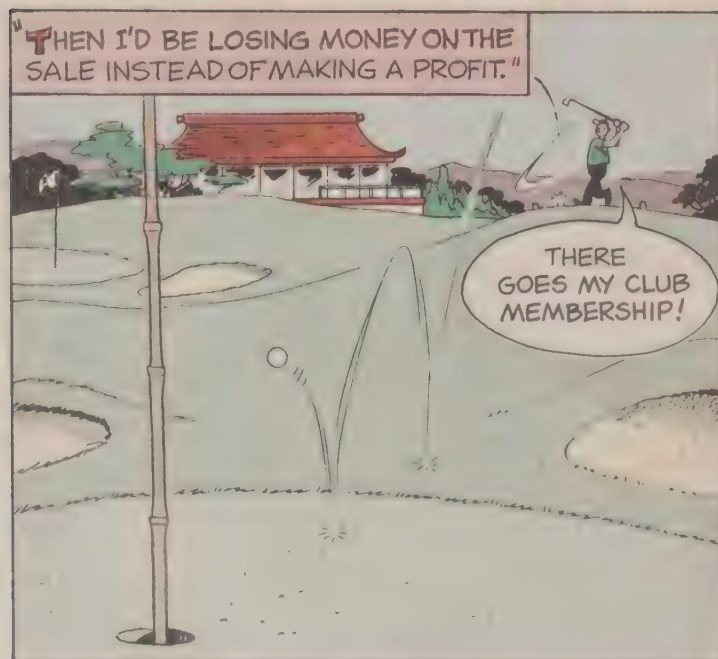
AT 300 YEN TO THE DOLLAR RIGHT NOW, 600 MILLION YEN EQUALS \$2 MILLION, THE AGREED UPON PRICE IN DOLLARS.

EXCHANGE RATE	
YEN	DOLLARS
600,000,000	2,000,000

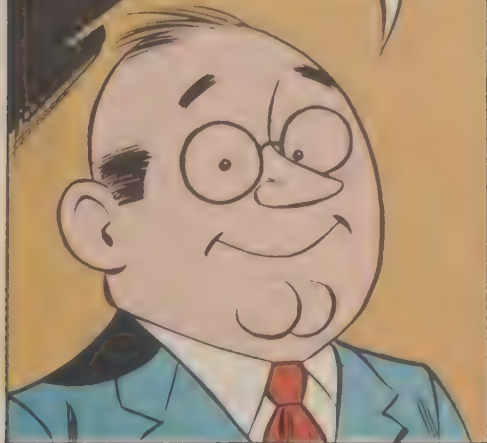


THEN I WILL GET ONLY 500 MILLION YEN FOR THE \$2 MILLION, 100 MILLION YEN LESS THAN I WOULD GET TODAY."

EXCHANGE RATE	
YEN	DOLLARS
500,000,000	2,000,000



OUR JAPANESE BUSINESS-
MAN KNOWS HE CAN COVER
THIS RISK WITH A FORWARD
FOREIGN EXCHANGE CONTRACT.
HERE'S WHAT HE WOULD DO.

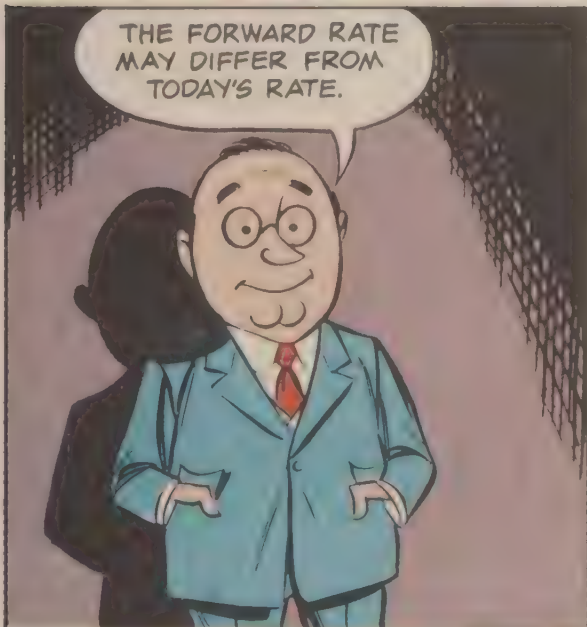


HE WOULD SELL THE DOLLARS HE WILL GET IN THREE
MONTHS, SELLING THEM AT A PRICE HE AND HIS BANKER
AGREE ON TODAY.

STILL OPEN!
I HOPE WE CAN
MAKE A DEAL!

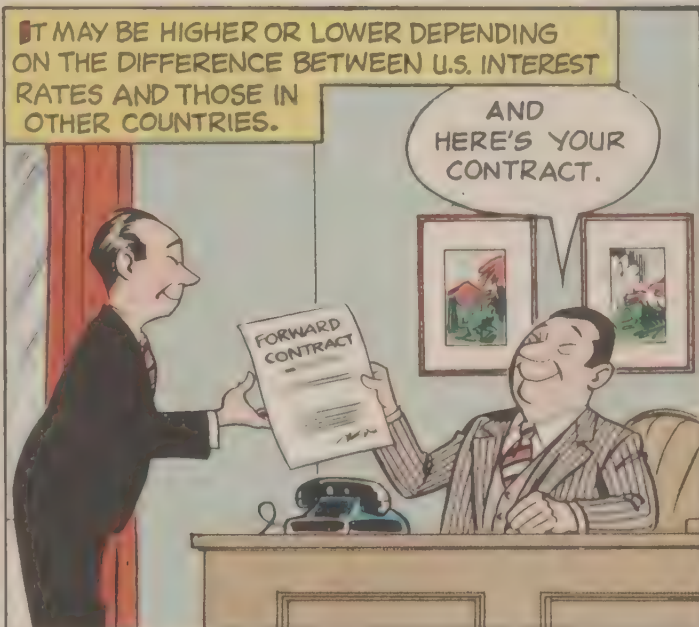


THE FORWARD RATE
MAY DIFFER FROM
TODAY'S RATE.

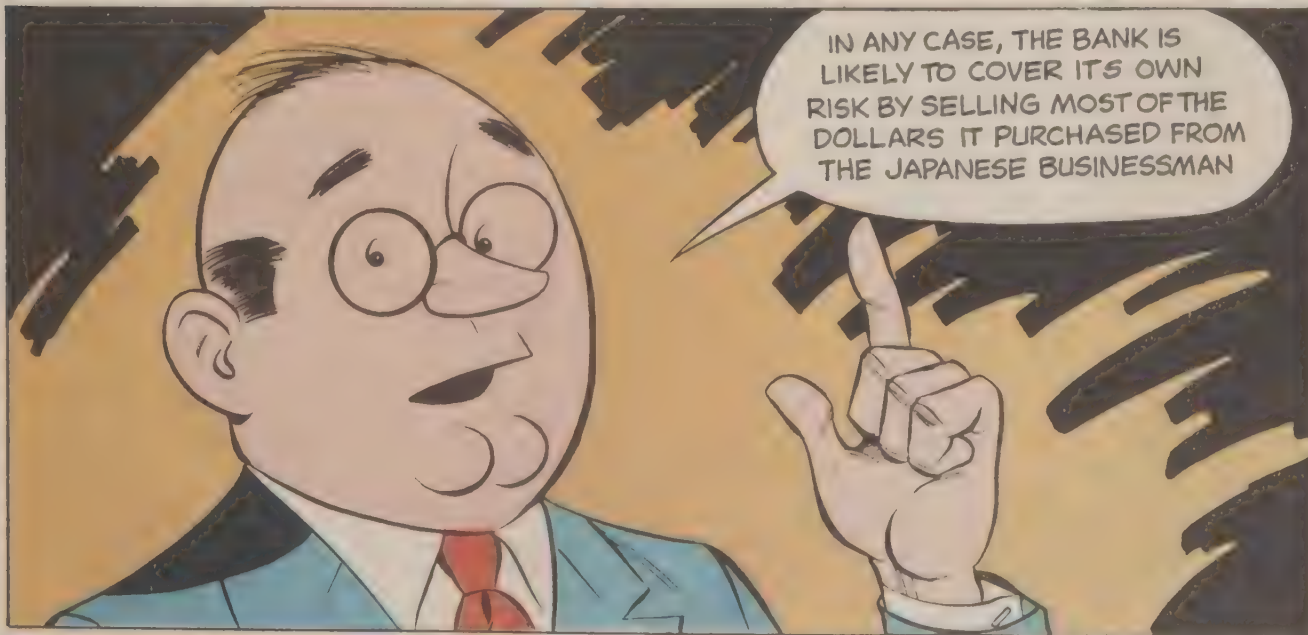


IT MAY BE HIGHER OR LOWER DEPENDING
ON THE DIFFERENCE BETWEEN U.S. INTEREST
RATES AND THOSE IN
OTHER COUNTRIES.

AND
HERE'S YOUR
CONTRACT.



IN ANY CASE, THE BANK IS
LIKELY TO COVER ITS OWN
RISK BY SELLING MOST OF THE
DOLLARS IT PURCHASED FROM
THE JAPANESE BUSINESSMAN



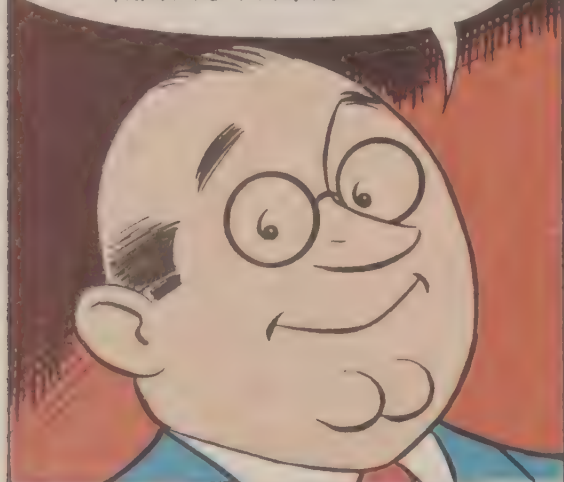
IT COULD SELL THE DOLLARS FORWARD TO A JAPANESE HAMBURGER KING, WHO IS IMPORTING TEXAS BEEF THAT HE'LL HAVE TO PAY FOR IN THREE MONTHS.

AND HERE'S A CONTRACT FOR YOUR DOLLARS WHICH ARE DUE IN THREE MONTHS.

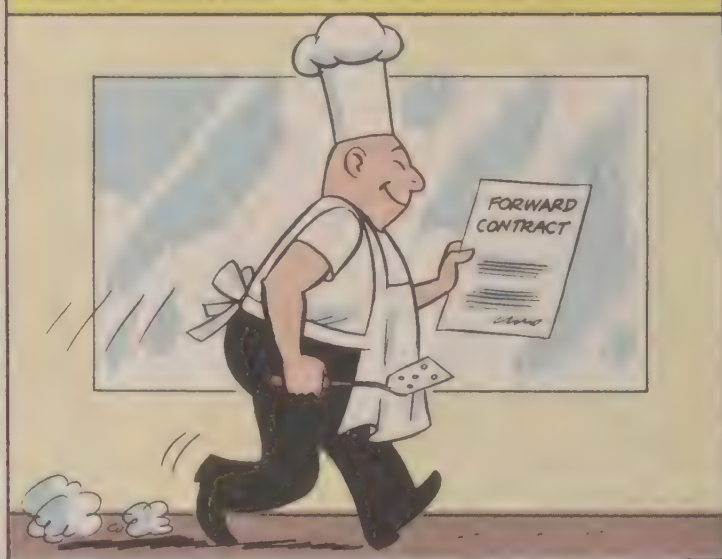
VERY GOOD—HAMBURGER-MAKERS NEED PROTECTION TOO!



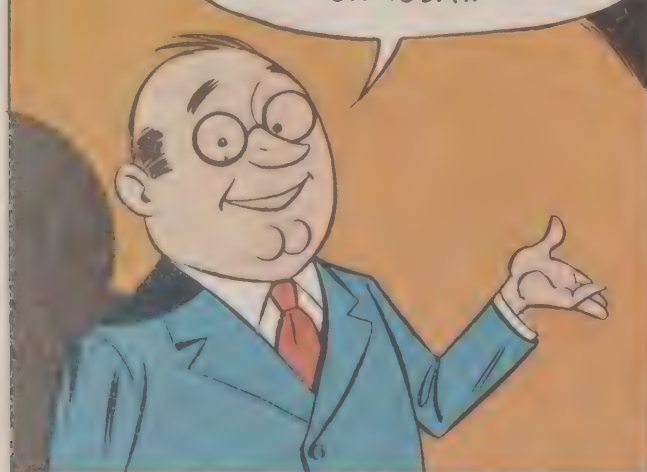
THE HAMBURGER KING IS PROTECTING HIMSELF TO MAKE SURE HE DOESN'T HAVE TO SPEND MORE YEN FOR EACH DOLLAR THAN HE PLANNED.



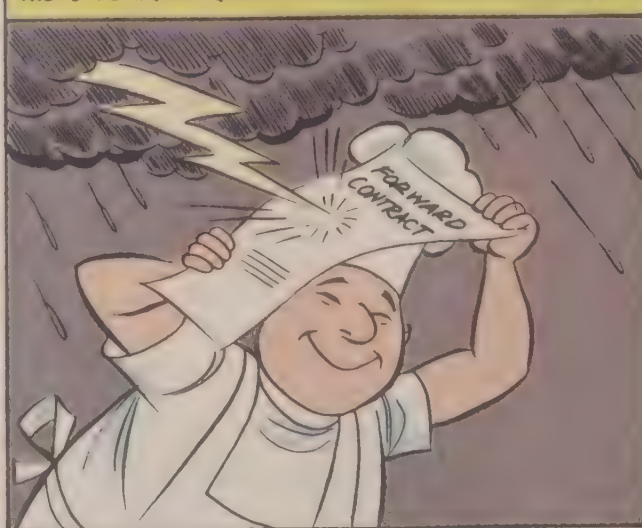
BY TAKING OUT A FORWARD PURCHASE CONTRACT HE PROTECTS HIMSELF FOR A FEE.



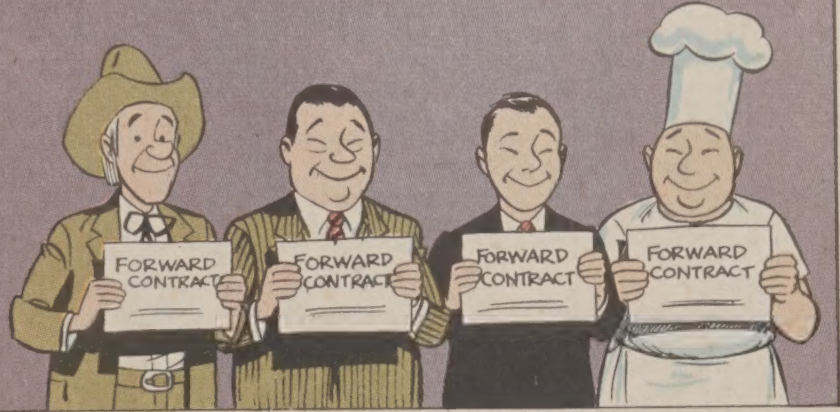
THE HAMBURGER KING BUYS DOLLARS FROM THE BANK FOR DELIVERY IN THREE MONTHS AT A PRICE AGREED ON TODAY.



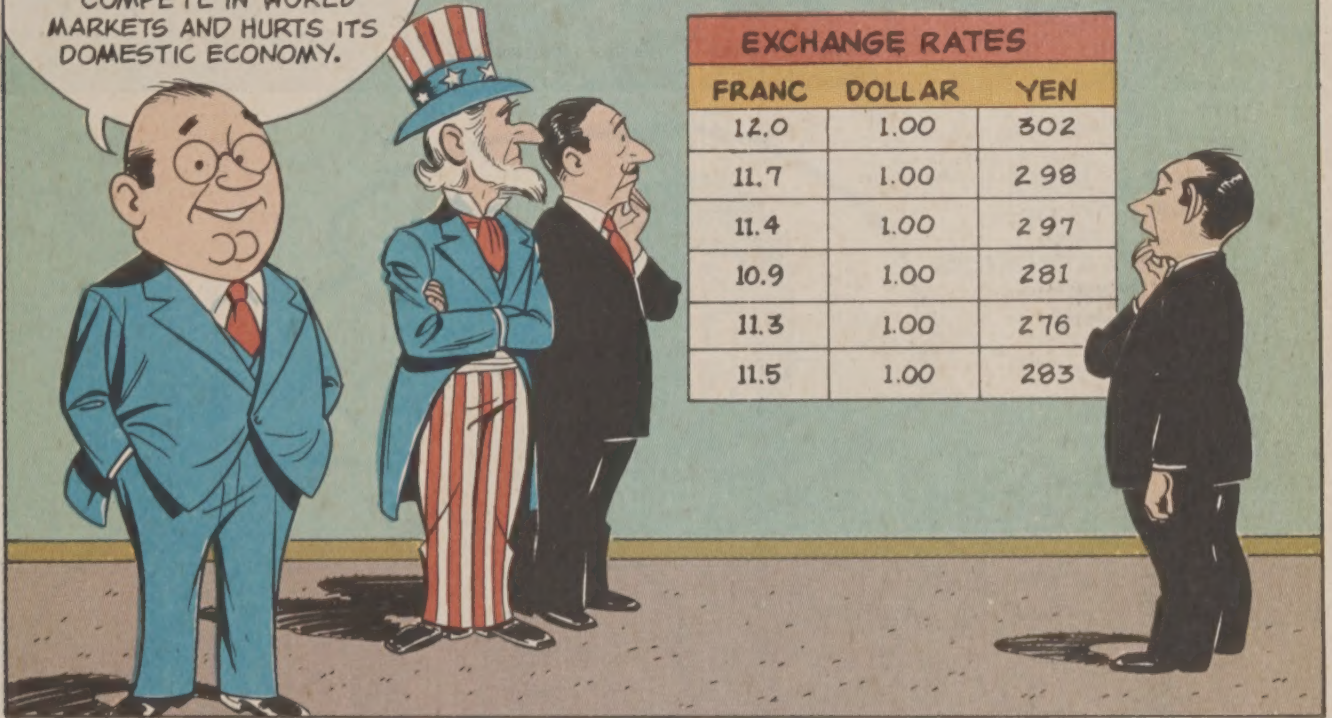
EVEN IF THE DOLLAR EXCHANGE RATE RISES THE HAMBURGER KING IS COVERED BECAUSE HIS DOLLARS HAVE ALREADY BEEN BOUGHT.



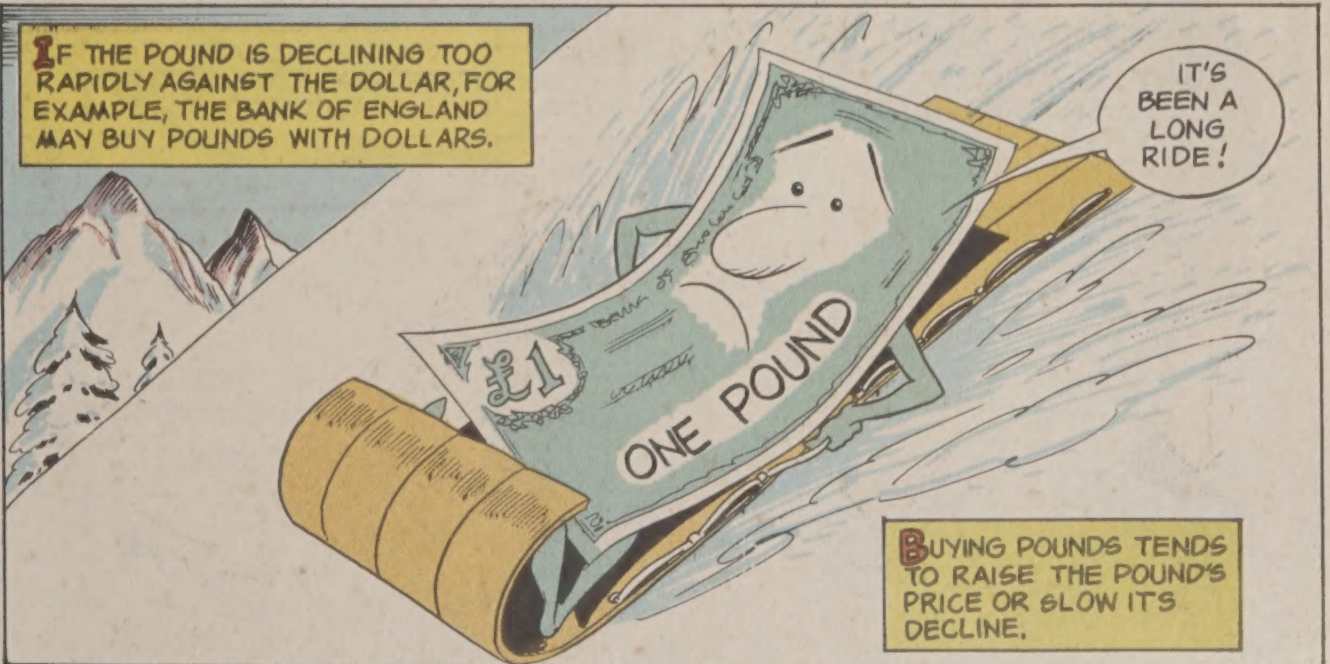
PEOPLE LIKE TEX, AND TRADERS LIKE THE JAPANESE HAMBURGER KING, AREN'T THE ONLY ONES WHO CARE ABOUT EXCHANGE RATES.



GOVERNMENTS CARE, TOO. ERRATIC EXCHANGE RATE MOVEMENTS CAN WEAKEN THE CONFIDENCE OF TRADERS AND INVESTORS. THIS AFFECTS A COUNTRY'S ABILITY TO COMPETE IN WORLD MARKETS AND HURTS ITS DOMESTIC ECONOMY.



IF THE POUND IS DECLINING TOO RAPIDLY AGAINST THE DOLLAR, FOR EXAMPLE, THE BANK OF ENGLAND MAY BUY POUNDS WITH DOLLARS.



BUYING POUNDS TENDS TO RAISE THE POUND'S PRICE OR SLOW ITS DECLINE.

OR IF THE GERMAN MARK IS RISING EXTREMELY RAPIDLY AGAINST THE DOLLAR, THE GERMAN CENTRAL BANK MAY SELL MARKS FOR DOLLARS. SELLING MARKS TENDS TO LOWER THE MARK'S PRICE OR SLOW ITS ASCENT.

STILL CAN'T SEE THE SUMMIT!



CENTRAL BANKS FROM TIME TO TIME BUY AND SELL THEIR CURRENCIES WITH FOREIGN EXCHANGE.



ONE BROAD GOAL OF THIS OCCASIONAL
INTERVENTION IS TO ENSURE THAT FOREIGN EX-
CHANGE MARKETS DO NOT BECOME DISORDERLY.
THEN, AS NATIONS AND AS INDIVIDUALS WE CAN
ENJOY EXPANDING PRODUCTION AND CONSUMPTION
THAT COMES FROM TRADE AND HAVING MONEY
TO TRADE.



INTERNATIONAL ECONOMICS is a multimedia package from the Federal Reserve Bank of New York designed for senior high school and freshman college students. The program contains the following: two full-color filmstrips with two seven-minute audio cassettes (each with audible and inaudible pulsing); four spirit-duplicating student activity masters; a comprehensive teacher's guide; a primer for teachers, *The Basics of Foreign Trade and Exchange*; and thirty-five copies of *The Story of Foreign Trade and Exchange*.

Price: \$35.95. Please make checks payable to the Federal Reserve Bank of New York. All orders, except official school purchase orders, must be prepaid. Invoices are payable on receipt of the materials. Orders should be sent to the address below.

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The Story of Banks
The Story of Checks
and Electronic Payments
The Story of Consumer Credit
(in English or Spanish)
The Story of Inflation
The Story of Money

FEDERAL RESERVE BANK OF NEW YORK

Public Information Department

33 Liberty Street • New York, N.Y. 10045

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